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LEGAL EFFECT OF PREINCORPORATION SUBSCRIPTION AGREEMENTS IN CALIFORNIA

In California preincorporation subscription agreements usually take the form of promises by subscribers or prospective shareholders to purchase stock in a proposed corporation, or unissued shares in an existing corporation.[1] While California statutes establish several minimum requirements which must be met,[2] all other aspects of preincorporation subscription agreements are controlled by contract principles.[3] Many American case decisions have held that preincorporation subscriptions, usually in the form of promises made by subscribers to the future corporation, are revocable prior to actual incorporation.[4] A minority view argues that mutual promises made by several subscribers to the same venture result in an agreement binding from the date of execution of the subscription itself.[5] California has never clearly decided which view it will follow,[6] and the statutes are silent on the matter.[7]

It may be desirable to those using preincorporation subscriptions that they be in law what they purport to be in fact: legally binding upon the parties and, unless a contrary intention appears, irrevocable from the beginning. The purpose of this note is to consider critically the prevalent contract theories and relevant statutory provisions, and also to suggest alternatives and techniques in using preincorporation subscription agreements in California.[8]

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[1] "Under California law an agreement by prospective shareholders to purchase stock in a proposed corporation, or unissued shares in an existing corporation, is a binding and enforceable contract." Hoppe v. Rittenhouse, 279 F.2d 3, 8 (9th Cir. 1960). "[A]ny agreement to take stock in a corporation is a subscription." Brown v. North Ventura Road Dev. Co., 216 Cal. App. 2d 227, 233, 30 Cal. Rptr. 568, 571 (1963). See Frey, *Modern Development in the Law of Preincorporation Subscriptions*, 79 U. PA. L. REV. 1005 (1929). "'[P]reincorporation subscription' denotes a written or oral manifestation, made to a person engaged in the enterprise of forming an identifiable corporation, of the subscriber's consent to become a shareholder of shares of a designated class and number in the proposed corporation and to pay an ascertainable sum thereto." *Id.* at 1005.

[2] CAL. CORP. CODE §§ 25153, 25500. See text accompanying notes 65-76 *infra*.

[3] The consequence of the application of contract principles to preincorporation subscriptions has not been altogether satisfactory. See text accompanying note 52 *infra*.

[4] See note 17 *infra*.

[5] See note 23 *infra*.

[6] Research has failed to locate a single California case where the subscriber has sought to withdraw before incorporation.

[7] While sections of the Corporate Securities Act, CAL. CORP. CODE §§ 25000-26104, set up requirements for preincorporation subscriptions, no California statute has been found which makes preincorporation subscriptions irrevocable for a period of time prior to incorporation. See discussion of relevant California statutes accompanying notes 65-76 *infra*.

[8] ABA MODEL BUS. CORP. ACT ANN. § 16(1960) provides that subscriptions shall be irrevocable for 6 months.

Preincorporation Subscriptions: Pro and Con

Several practical advantages may be realized through the use of preincorporation subscriptions by a group organizing a corporation. The primary use of these agreements is to raise capital with which to finance the future corporation.[9] Often the organizers wish to obtain needed capital from a number of persons outside their own group. Ultimate receipt of such capital may be better assured and potential financial embarrassment avoided if each potential investor is bound by a contract to put up a specific amount of money for a specific number of shares. This obligation becomes operative as soon as the corporation is formed and an appropriate permit has been obtained.[10]

The preincorporation subscription agreement can also be used to set forth matters relevant to the corporate formation. These matters include the form and manner of incorporation, the allotment of shares to each subscriber, the consideration to be paid for the shares, the terms of payment for the shares, the prospective source of future funds, the determination of the original board of directors, the determination of the original corporate officers, compensation to officers and directors, classes of shares to be established, and the rights, privileges and preferences attendant to each class of shares.[11]

A potential disadvantage of preincorporation subscriptions is that if California follows the majority "revocable offer" theory, these agreements may be illusory before incorporation.[12] The practical consequences of the subscriber's right to revoke are: uncertainty as to the amount of funds a proposed corporation will have available to it upon incorporation, or even, the possibility that there will be insufficient funds to permit its formal organization.[13] The dicta in California cases are contradictory and fail to illuminate the path a California court might choose in deciding a controversy directly in point.[14]

The Common Law Views

Before legislation regulating corporate activities became widespread,[15] the courts interpreted preincorporation subscriptions entirely through the application of contract principles.[16] The results

[9] Frey, *supra* note 1, at 1005.

[10] ADVISING CALIFORNIA BUSINESS ENTERPRISES 505 (Cal. Cont. Educ. Bar ed. 1958). The money subscribed cannot be collected until a permit for that purpose has been issued by the California Corporation Commissioner. CAL. CORP. CODE § 25153(b)(1). If desired, such a permit may be obtained prior to the date of incorporation. CAL. CORP. CODE § 25516.

[11] Winton, *Private Corporate Stock Subscription Agreements*, 33 S. CAL. L. REV. 388, 389 (1960).

[12] This disadvantage assumes the typical language of a subscription which is directed solely to the future corporation and not to the other subscribers. See note 83 *infra* and accompanying text.

[13] 4 Z. CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 86.02(1)(a) (1967).

[14] See California case law discussion accompanying notes 36-51 *infra*.

[15] Winton, *supra* note 11, at 390.

[16] See note 1 *supra*.

have been diverse. Many American decisions[17] have stated that a subscription is not binding until the corporation has come into existence and has "accepted" the subscriber's "offer."[18] The courts have reasoned that withdrawal without liability naturally follows in any situation where (a) there has been no acceptance, no mutuality or meeting of minds and therefore no consideration,[19] and (b) the contemplated offeree is not yet in legal existence and is obviously incapable of entering any contractual agreement.[20] Courts following the majority point of view have gone on to hold that in spite of mutual promises made by several subscribers contemplating the same objective, none of the subscribers is deprived of a "right to withdraw" from the subscription agreement before incorporation occurs.[21] These cases seem to conclude that each subscriber's promise to take and pay for shares is directed solely to the proposed corporation and therefore is not sufficient legal consideration to support the promises of the others to likewise take shares, even though the other subscribers may have acted to their detriment on the strength of the withdrawer's purported subscription, or even though he may have induced the others to subscribe.[22]

Several courts following the minority viewpoint have argued that a preincorporation subscription entered into by a number of persons constitutes a contract between the subscribers themselves to become stockholders when the corporation is formed pursuant to the terms of the subscription agreement.[23] Such an agreement is binding and irrevocable from the date of subscription and amounts to a "continuing offer" to the corporation which brings the corporation in as a party after its legal formation.[24] These cases have reasoned that when several parties agree to contribute to a common object which they wish to accomplish, the promise of each is a good consideration for the promise of the others and ripens into a binding contract among the parties.[25]

Several early California cases have suggested two other possibilities that have not gained widespread acceptance. First, the subscribers could enter into an agreement with a trustee who, in execution of an express trust, would bring the corporation into existence.[26]

[17] Collins v. Morgan Grain Co., 16 F.2d 253 (9th Cir. 1926); Bryant's Pond Steam Mill Co. v. Felt, 87 Me. 234, 32 A. 888 (1895); Hudson Real Estate Co. v. Tower, 156 Mass. 82, 30 N.E. 465 (1892); Buffalo & N.Y. City Ry. Co. v. Dudley, 14 N.Y. 336 (1856); Muncy Traction Engine Co. v. Green, 148 Pa. 269, 13 A. 747 (1888).

[18] Additional cases collected in Annot., 61 A.L.R. 1463 (1929).

[19] Collins v. Morgan Grain Co., 16 F.2d 253, 254 (9th Cir. 1926).

[20] *Id.*

[21] *E.g.*, Athol Music Hall Co. v. Carey, 116 Mass. 471 (1874), discussed in text accompanying note 45 *infra*.

[22] Bryant's Pond Steam Mill Co. v. Felt, 87 Me. 234, 32 A. 888 (1895).

[23] Minneapolis Threshing Mach. Co. v. Davis, 40 Minn. 110, 41 N.W. 1026 (1889); Coleman Hotel Co. v. Crawford, 3 S.W.2d 1109 (Tex. Civ. App. 1928).

[24] Coleman Hotel Co. v. Crawford, 3 S.W.2d 1109, 1110 (Tex. Civ. App. 1928).

[25] *Id.*

[26] West v. Crawford, 80 Cal. 19, 21 P. 1123 (1889). *But see* San Joaquin Land & Water Co. v. West, 94 Cal. 399, 29 P. 785 (1892) (where trustee approach was not approved in case arising out of the same fact situation). See discussion in text accompanying note 64 *infra*.

The second possibility would be to treat the corporation as the mutually contemplated third party beneficiary of the subscription agreement.[27] Such an approach would allow the corporation to enforce the subscription after incorporation even though it were not a party thereto originally.[28]

Even those jurisdictions espousing the majority "revocable offer" theory recognize that a subscription agreement might be framed in a way that will bind its subscribers from the time of its execution.[29] For instance, if there is consideration in addition to the mutual promises moving to a subscriber, the contract in its entirety would be binding from the beginning.[30] Also, a preincorporation subscription would be binding when it contains an authority coupled with an interest.[31] For example, a subscriber might give authority to the organizing group to take over his property, to perfect his subscription, and to do anything necessary to constitute him a stockholder.[32] The interest of the promoters would render the authority granted them, and therefore the subscription, irrevocable.[33]

California Case Law

An affirmative answer to the question of whether a subscriber may withdraw before incorporation is found in *Moser v. Western Harness Racing Ass'n.*[34] An attorney employed under a written contract by the defendant corporation recovered a judgment for wrongful discharge. The defendant corporation appealed on the grounds that the discharge was justified because the plaintiff had tendered erroneous legal advice. The plaintiff, one of the group that organized the defendant, had drawn a preincorporation subscription signed by one Rogers and others. *After* incorporation, at the first meeting of the board of directors, the plaintiff advised that because of Rogers' alleged insolvency the corporation need not accept his subscription offer.[35] Following this advice, the directors allotted Rogers' shares

[27] Horseshoe Pier Amusement Co. v. Sibley, 157 Cal. 442, 108 P. 308 (1910) (case also raises trustee possibility). See criticism of third party beneficiary theory in text accompanying note 62 *infra.*

[28] *Id.*

[29] Chicago Bldg. & Mfg. Co. v. Peterson, 133 Ky. 596, 118 S.W. 384 (1909); Knox v. Childersburg Land Co., 86 Ala. 180, 5 So. 578 (1888) (dictum).

[30] Where subscribers contracted with a manufacturing company to erect and equip a factory to be used by the proposed corporation, the subscription was held irrevocable. Chicago Bldg. & Mfg. Co. v. Peterson, 133 Ky. 596, 118 S.W. 384 (1909).

[31] *In re* Hannan's Empress Gold Mining & Dev. Co., [1896] 2 Ch. 643.

[32] *See id.* at 644-45 for just such an agreement which was held binding by the court.

[33] *Id.* at 647-48.

[34] 89 Cal. App. 2d 1, 200 P.2d 7 (1948).

[35] It seems definitely settled in the United States and in California that the mere fact of incorporation pursuant to the terms of the subscription accepts the offer of the subscribers and renders each of them liable to the corporation in the amount subscribed. San Joaquin Land & Water Co. v. Beecher, 101 Cal. 70, 35 P. 349 (1894); 1 H. BALLANTINE & G. STERLING, CALIFORNIA CORPORATION LAWS § 108 (4th ed. 1967). Of course, the corporation must be the exact one the subscribers contemplated. California Sugar Mfg. Co. v. Schafer, 57 Cal. 396 (1881); Marysville Elec. Light & Power Co. v.

to others. Rogers subsequently enforced his agreement against the corporation. In holding the plaintiff's advice to be professionally unsound the appellate court said:

> The validity of preorganization subscription agreements conforming to statutory regulations is universally recognized, and but with slight research a wealth of authority on the subject is readily available. The following principles are thoroughly established: (1) Ordinarily, a subscription may be withdrawn at any time before the proposed corporation is formed; (2) in California the subscription becomes binding upon the subscriber and the corporation when the corporation is formed, in the absence of special circumstances or an agreement to the contrary; (3) if, under the circumstances of the particular case there is an implied or express agreement for withdrawal of the subscription prior to acceptance of the same by the corporation, action by the corporation approving the subscription will be deemed an acceptance, and the subscription will thereupon become binding upon the subscriber and the corporation.[36]

As the facts recited above indicate, the court was called upon to decide when acceptance occurred, that is, when the defendant corporation became bound to its subscribers. Thus, postulates (2) and (3) are relevant to the problem faced by the *Moser* court.[37] Postulate (1) is merely dictum and raises several questions by its inclusion in the court's opinion. Did the court mean to announce that California adheres to the majority "revocable offer" theory? It cited no California authorities so holding.[38] Possibly the court was indicating its preference, or it may have been saying that the corporation had no redress if all subscribers agreed to revoke the subscription before incorporation. In any event postulate (1) seems contrary to the sentence immediately preceding it to the effect that the validity of preorganization subscriptions is universally recognized. Does universal recognition of validity attach before (minority view) or after (majority view) incorporation? The questions raised by the court's statement of postulate (1) point out the unclear state of California law on the legal effect of preincorporation subscriptions. If the *Moser* court was stating a preference for the majority rule, its view might be in conflict with that of the California Supreme Court as expressed in dicta in early cases.[39] In *Marysville Electric Light &*

Johnson, 109 Cal. 192, 41 P. 1016 (1895); Crittenden v. Credit Foncier des Etats Unis, 94 Cal. App. 200, 270 P. 1016 (1928). However, it is not necessary that all of the original subscribers participate in the final incorporation. Ferrochem Co. v. Danziger, 23 Cal. App. 584, 138 P. 966 (1913).

[36] 89 Cal. App. 2d at 9, 200 P.2d at 11.

[37] *Id.* Postulates (2) and (3) seem well founded in California cases. See note 35 *supra.*

[38] None of the cited cases involved withdrawal or disclaimer of liability prior to incorporation. *Compare* Christian College v. Hendley, 49 Cal. 347 (1874), *with* San Joaquin Land & Water Co. v. Beecher, 101 Cal. 70, 35 P. 349 (1894) (both cited as authority by the *Moser* opinion).

[39] In a case where subscribers formed a plan to erect a college, the California Supreme Court said: "If 'a number of subscribers promise to contribute money on the faith of the common agreement, for the accomplishment of an object of interest to all, and which cannot be accomplished save by their common performance, then it would seem that the mutual promises constitute reciprocal obligations.' " Christian College v. Hendley, 49 Cal. 347, 350 (1894) (dismissed on insufficient pleading) *quoting from* Watkins v. Eames, 63 Mass. (9 Cush.) 537, 539 (1852).

Power Co. v. Johnson[40] a corporation recovered upon a preincorporation subscription agreement signed by the defendant and others. After the plaintiff was incorporated the defendant refused to pay calls made upon the amount for which he had subscribed. Following a recitation of the subscription agreement, the court said:

> The agreement above set out is certainly valid; the corresponding promises of the other signers, and the common object sought to be accomplished by all parties to it, constitute a sufficient consideration for the promise of defendant; and upon the formation of the plaintiff corporation by the persons signing the agreement, and plaintiff's acceptance of the agreement, the defendant became bound to take and pay for the number of shares subscribed for by him.[41]

From the facts of *Marysville* it is clear that the court was limited to consideration of the legal effect of the agreement after incorporation. Thus, the court's statement to the effect that the common object sought to be accomplished constituted a sufficient consideration for defendant's promise is dictum. However, the court seems to recognize that while no one could be bound to an unformed corporation, one might be bound through a subscription contract to his fellow subscribers to act in good faith in not withdrawing prior to incorporation. But, it must be pointed out that the *Marysville* court went on to quote with apparent approval from a Massachusetts case[42] clearly following the "revocable offer" theory:

> "The promise of each subscriber 'to and with each other' is not a contract capable of being enforced . . . between each subscriber and each other who may have signed previously . . . nor between each subscriber and all the others collectively as individuals."[43]

While the quoted case went on to hold a subscriber bound after incorporation and was thus authority for the *Marysville* decision, the language quoted above from the Massachusetts case greatly undermines the worth of the language used by the California Supreme Court.

Considering preincorporation subscriptions, a distinguished writer, Paul A. Winton,[44] suggests that there is no doubt but that California has followed the majority view from an early time. For support he cites to dicta in early cases to the effect that until incorporation, subscription agreements are merely *executory*.[45] While use of the word *executory* is unfortunate,[46] these early cases may have used the word to mean *unenforceable*.[47] At least this argument could be made in support of Mr. Winton's interpretation. He goes on to list five postulates he says cover the legal consequences of preincorporation subscriptions in California.[48] His first three are verbatim

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[40] 93 Cal. 538, 29 P. 126 (1892).

[41] *Id.* at 546, 29 P. at 127.

[42] Athol Music Hall Co. v. Carey, 116 Mass. 471 (1874).

[43] 93 Cal. at 547, 29 P. at 127 *quoting* 116 Mass. at 473.

[44] Winton, *supra* note 11, at 390.

[45] *Id.* See cases cited note 47 *infra.*

[46] CAL. CIV. CODE § 1661 (enacted 1872) tacitly recognizes that executory contracts may be valid.

[47] Winton, *supra* note 11, at 390 n.8, *citing* San Joaquin Land & Water Co. v. Beecher, 101 Cal. 70, 35 P. 349 (1894); California Hotel Co. v. Callender, 94 Cal. 120, 29 P. 859 (1892); Marysville Elec. Light & Power Co. v. Johnson, 93 Cal. 538, 29 P. 126 (1892). *See also* 6A CAL. JUR. *Corporations* § 251 (1932).

[48] Winton, *supra* note 11, at 394.

extracts of the three *Moser* postulates set out above, and his last two are corollaries well founded in California case law.[49] Again, California has never directly decided to follow postulate (1) allowing a subscriber to withdraw without liability before incorporation. On this point California law is not clear, and its postulation may be misleading, *Moser* notwithstanding.

Critical Look at the Contract Approach

In adopting a rule of law to follow, one must compare the legal interests sought to be protected. By comparing the subscriber's interest to that of the corporation or to that of the promoter, one gains a clearer understanding of how the prevalent common law theories developed. In explanation of the "revocable offer" theory it has been suggested that a great number of the early American courts were willing to allow withdrawal of preincorporation subscriptions at least until after the corporation was formed because the judges viewed promoters of new enterprises as "glib and persuasive individuals," and investors as "gullible and credulous persons."[50] It is easily understood that the courts sought to protect unwary subscribers from exploitation. Today, the situation is different. Transfer and sale of securities have come under strict statutory regulation.[51] Such regulation seems to have left the corporate organizers in a weaker legal position than the nonpromoter subscribers who have not only the "revocable offer" theory as a majority common law viewpoint in their favor but also statutory protection. Under today's circumstances, it is clear that the "revocable offer" theory not only fails to protect all parties to the subscription, but it also has no reasonable basis where protection is accomplished through statutes. Strong objections have been leveled at the basic reasoning underlying this

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[49] Mr. Winton appears not to have cited to any direct authority for his first postulate other than the majority common law viewpoint: "(1) Ordinarily, a subscription may be withdrawn at any time before the proposed corporation is formed." *Id.* This is a direct quotation from Moser v. Western Harness Racing Ass'n, 89 Cal. App. 2d 1, 200 P.2d 7 (1948). The objections discussed in the text accompanying note 38 are applicable. Postulates (4) and (5) are worth noting: "(4) If a valid preincorporation subscription agreement is in effect when the corporation is formed and the corporation is legally competent to issue its shares, the subscribers will be bound by the terms of the agreement." Winton, *supra* note 11, at 394; *see* Coast Amusements, Inc. v. Stineman, 115 Cal. App. 746, 2 P.2d 447 (1931). "(5) The subscriber may be bound by an invalid or void preincorporation subscription agreement in certain limited situations, *e.g.*, where the rights of creditors or other innocent third parties have intervened." Winton, *supra* note 11, at 395. *See* Moore v. Moffatt, 188 Cal. 1, 204 P. 220 (1922). *But cf.* Smith v. Turner, 238 Cal. App. 2d 141, 47 Cal. Rptr. 582 (1965).

[50] Frey, *supra* note 1, at 1012.

[51] CAL. CORP. CODE § 25500: "No company shall sell any security of its own issue, . . . or offer for sale, negotiate for the sale of, or take subscriptions for any such security, until it has first applied for and secured from the commissioner a permit authorizing it so to do. . . ." § 25003: " 'Company' includes all of the following: (a) All domestic and foreign private corporations, associations, syndicates, joint stock companies, and partnerships of every kind. (b) Trustees . . . . (c) Individuals selling, offering for sale, negotiating for the sale of, or taking subscriptions for, any security of their own issue."

theory.[52] The substance of these objections is that an offer must be made to an offeree capable of accepting the offer; while using the term "revocable offer" this theory denies the existence of the only possible offeree, the proposed corporation, but turns around to hold that mere incorporation is an acceptance which ripens into a contract.[53] At least, it may be said that courts have applied contract reasoning to preincorporation subscriptions with an uncharacteristic looseness in logic.[54]

The reasoning of the minority "continuing offer" view is just as tenuous as that of the majority view. However, the minority position strikes a more acceptable balance among all organizing interests in need of protection. The usual subscription agreement makes no reference to or provision for revocation prior to incorporation.[55] However, the subscription, under this viewpoint, is interpreted by the court to contain an implied promise not to revoke. If such a promise had been expressly stated, it might not have been acceptable to the parties to the subscription. In addition, the practical problem of enforcement by the subscribers who have not attempted to withdraw must be considered.[56] It would seem difficult for them to prove that they cannot procure someone else to take the defaulter's place. Further, the value of the defaulter's performance may largely depend upon the success of the originally contemplated venture, which has become only a speculative possibility because of the default itself.[57] While the speculative nature of the damages might give rise to an argument urging specific enforcement of the agreement in equity, ultimate performance would be a payment of money; and, thus it appears that damages would be the only available remedy.[58]

Even the third party beneficiary and trustee theories are not without their limitations.[59] Arguments have been made that laymen organizing a corporation are seldom dealing for the benefit of a third party, "a juridical third party of whose imminent existence they are unaware."[60] Subscribers are usually dealing for themselves. In getting together they propose to divide the burdens and benefits of a prospective business. Furthermore, it has been held that a newly formed corporation may be bound by the antecedent preincorporation subscription agreement.[61] According to accepted contract principles, a third party beneficiary is never bound to accept the bounty of a contract made for his benefit.[62] Thus this approach breaks down as

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52 Schwenk, *Preincorporation Susbscriptions: The Offer Theory and—What is an Offer?*, 29 VA. L. REV. 460 (1943).

53 *Id.* at 477-78. See note 35 *supra.*

54 *Id.* at 462.

55 See note 83 *infra,* which sets forth a suggested form of subscription agreement.

56 Morris, *The Legal Effect of Preincorporation Stock Subscriptions,* 34 W. VA. L.Q. 219, 232 (1928).

57 *Id.*

58 *See, e.g.,* Deschamps v. Loiselle, 50 Mont. 565, 148 P. 334 (1915).

59 See notes 26-27 *supra.*

60 Morris, *supra* note 56, at 231.

61 *Id.*

62 RESTATEMENT OF CONTRACTS § 137 (1932).

a legal argument. The trustee theory may have merit if it can be said that the promises to take and pay for stock in a proposed corporation constitute a sufficient trust res to support an express trust.[63] A California case has been unwilling to go this far.[64] It appears that all of these common law approaches have limitations which suggest that a new approach should be sought.

California Statutory Limitations

As stated above, California has no statutory provisions making preincorporation subscriptions irrevocable. However, the Corporate Securities Act[65] recognizes these agreements in one of its important provisions. The statute directly applicable is section 25153 of the California Corporations Code. It provides in part that:

> (a) No provision of the Corporate Securities Law prohibits subscriptions for securities . . . of a domestic or foreign corporation made prior to the incorporation thereof . . .; but each such subscription is made and accepted upon the following conditions: (1) The corporation shall be incorporated within 90 days thereafter. (2) The corporation when incorporated, . . . shall with reasonable diligence apply for and secure from the commissioner a permit authorizing the issue of the securities or the sale of the interests so subscribed for, in accordance with such subscription.[66]

This paragraph has the effect of excluding preincorporation subscriptions from a permit requirement as set forth in section 25500 of the Corporations Code.[67] California cases have clearly established that when the organizing group enters a preincorporation subscription, the Corporate Securities Act becomes a part of that agreement,[68] and unless the conditions and requirements of the Act are met, the agreement is not enforceable.[69] It is clear that the conditions enumerated in section 25153 operate as conditions subsequent; thus, where there was a delay in excess of 90 days in achieving formal incorporation,[70] or where the newly formed corporation had not

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[63] 26 GEO. L.J. 749, 755 (1939).

[64] San Joaquin Land & Water Co. v. West, 94 Cal. 399, 29 P. 785 (1892). *But see* Horseshoe Pier Amusement Co. v. Sibley, 157 Cal. 442, 108 P. 308 (1910); May v. State, 127 So. 2d 423 (Miss. 1961) (promoter in "quasi-trustee" relation with both corporation and subscriber).

[65] CAL. CORP. CODE §§ 25000-26104.

[66] CAL. CORP. CODE § 25153 (omitted portions deal with real estate investment trusts); § 25153(b): "Except as is specifically required by any law of this State, nothing in this section permits only of the following:

"(1) The collection of any portion of the consideration to be paid on account of the subscriptions made prior to incorporation . . . unless and until a permit has been issued by the commissioner authorizing such collection.

"(2) The taking of subscriptions for any security of any company other than a domestic or foreign corporation . . . , or collection of any portion of the consideration to be paid on account of such subscriptions, unless and until a permit has been issued by the commissioner authorizing the taking of such subscriptions or the collection thereof."

[67] See note 51 *supra*.

[68] *E.g.*, Herkner v. Rubin, 126 Cal. App. 677, 14 P.2d 1043 (1932).

[69] California W. Holding Co. v. Merrill, 7 Cal. App. 2d 131, 46 P.2d 175 (1935).

[70] Herkner v. Rubin, 126 Cal. App. 677, 14 P.2d 1043 (1932); Norris (Harlie R.) Co. v. Lovett, 123 Cal. App. 640, 12 P.2d 141 (1932). *But see* Sargent

used reasonable diligence in securing a permit to issue its shares,[71] preincorporation subscriptions were held voided and legally unenforceable. To prevent unregulated sale of securities, section 25153 has been construed as precluding any right of inter vivos transfer or sale of preincorporation subscription rights.[72] To hold otherwise would mean that these rights could be sold by the organizing group, thereby skirting regulation by the corporation commissioner under provisions of the Corporate Securities Act.[73] Of the scant litigation in California involving the legal effect of preincorporation subscriptions, most has revolved around failure to comply in one respect or another with the conditions of section 25153. Thus, statutory compliance as a prerequisite to an enforceable preincorporation subscription cannot be overemphasized.[74]

Section 1300 of the California Corporations Code, while not a part of the Corporate Securities Act, is worthy of mention. It provides that "[e]very subscriber to shares and every person to whom shares are originally issued is liable to the corporation for the full consideration agreed to be paid for the shares."[75] In spite of suggestions that this statute is a substantial enactment of a section of the Model Business Corporation Act which provides that subscriptions are irrevocable,[76] the language of this statute would seem to preclude the corporation from enforcing a subscription prior to its actual incorporation, and no case has been found directly extending section 1300 to prevent a subscriber's attempted withdrawal prior to incorporation. While prior to incorporation the corporation would be powerless to enforce the subscription, section 1300 could easily be held applicable to prevent withdrawal. The other subscribers acting on behalf of the proposed corporation (and of course themselves) might bring the action, or it might be postponed until the 90 days have elapsed and the corporation has been brought into existence in compliance with subsection 25153(a)(1). After incorporation the corporation would be legally capable of bringing suit to enforce the agreement against a subscriber's prior attempted withdrawal.

Conclusion

So long as traditional contract principles are used by courts to control the law of corporate organization through the preincorporation subscription device, such principles will cast shadows of doubt upon the legal validity of these agreements. The corporate form of

v. Coppage, 47 Cal. App. 2d 122, 117 P.2d 412 (1941), holding subscriber bound though more than 90 days had elapsed from date of subscription to date of incorporation. "Nothing in the language of the act nor in the decisions interpreting it justifies a construction which would enable the plaintiff [subscriber] to thus extricate himself from an unsatisfactory investment." *Id.* at 126, 117 P.2d at 414.

[71] Norris (Harlie R.) Co. v. Lovett, 123 Cal. App. 640, 12 P.2d 141 (1932).

[72] First Nat'l Bank v. Thompson, 212 Cal. 388, 298 P. 808 (1931).

[73] *Id.* at 403, 298 P. at 814.

[74] For an excellent discussion of California cases interpreting applicable statutes, see Winton, *supra* note 11, at 390-94.

[75] CAL. CORP. CODE § 1300.

[76] 26 GEO. L.J. 749, 757 n.53; ABA MODEL BUS. CORP. ACT ANN. § 16, at 298 (1960).

business organization is not furthered by such a prospect. To overcome the usual contract theory limitations three approaches are suggested. First, new legislation might be enacted. Second, various techniques might be employed by legal draftsmen in preparing preincorporation subscription agreements. Third, judicial interpretation could extend the operation of existing statutes to cover preincorporation subscriptions.

The California legislature could profitably follow the example of those states[77] which have grown dissatisfied with the contract approach and have passed provisions similar to section 16 of the Model Business Corporation Act:

> A subscription for shares of a corporation to be organized shall be irrevocable for a period of six months, unless otherwise provided for by the terms of the subscription agreement or unless all of the subscribers consent to the revocation of such subscription . . . .[78]

Such proposed legislation, if modified to read "irrevocable for a period of 90 days" so as to complement section 25153 would be a beneficial addition to the California Corporations Code.

Pending adoption of desirable legislation or judicial extension of existing statutes, several techniques have been suggested to make the legal enforceability of subscriptions more likely.[79] First, all the subscribers might promise to pay a third party for work performed, for the projected corporation, out of the proceeds of the subscriptions. In such circumstances the revocation by the subscriber would breach his contract with the third party.[80] Second, an agreement might be made among the subscribers whereby each undertakes not to revoke his subscription. The consideration for such an agreement is the promise of each subscriber not to revoke.[81] Third, the subscriber might make an express promise to pay on the happening of a stated contingency: for example, the incorporation and receipt of a permit to issue shares.[82] Any or all of these techniques might profitably be employed by draftsmen preparing preincorporation subscription agreements. A recommended form[83] does not appear to

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[77] A comparable statutory provision to section 16 of the *Model Business Corporation Act* is found in Alabama, Alaska, Colorado, Illinois, Iowa, Mississippi, Nebraska, North Carolina, North Dakota, Oregon, South Dakota, Texas, Utah, Washington, Wisconsin, Wyoming, District of Columbia. ABA MODEL BUS. CORP. ACT ANN. § 16, ¶ 2.01, 2.02(3) (1960). In Idaho, Louisiana, and Washington the period is 1 year. IDAHO CODE ANN. § 30-109 (1948); LA. REV. STAT. ANN. § 12:6 (1950); WASH. REV. CODE ANN. § 23.01.060 (1961). In New York the period is 3 months unless otherwise provided by the terms of the subscription or if all of the subscribers or the corporation itself consents to the revocation. N.Y. BUS. CORP. LAW § 503(a) (McKinney 1963).

[78] ABA MODEL BUS. CORP. ACT ANN. § 16 (1960).

[79] Cavitch, *supra* note 13, at § 86.02[1][a].

[80] *Id.* § 86.02[1][a](1).

[81] *Id.* § 86.02[1][a](2).

[82] *Id.* § 86.02[1][a](3).

[83] ADVISING CALIFORNIA BUSINESS ENTERPRISES 506 (Cal. Cont. Educ. Bar ed. 1958) recommended form:

> PREINCORPORATION SUBSCRIPTION AGREEMENT†
>
> WHEREAS, it is contemplated that a California corporation will be organized for the purpose of engaging in the business of manufacturing and selling plastic coatings for wood, metal, and other exposed surfaces, with an authorized capital consisting of 20,000 shares of common stock of the par value of $10 per share, under the corporate

utilize any of these techniques.

In the absence of appropriate legislation or a carefully drafted preincorporaation subscription agreement, resort might be made to the argument previously advanced in favor of the applicability of section 1300 of the Corporations Code. If the conditions of section 25153 have been fulfilled, there should be no reason why a new corporation could not bring suit under section 1300.

It is respectfully urged that clarification of California law by passage of appropriate legislation would be the most satisfactory solution to the problems outlined in this note. In the absence of such legislation, clarification of the law by the courts and specificity by legal draftsmen would enhance the legal certainty of preincorporation subscription agreements.

*David B. Harrison**

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name "PLASCO, INC.," or such other name as shall be mutually agreed upon by the undersigned; and

WHEREAS, each of the undersigned desires to subscribe for a designated number of the shares of said corporation;

NOW, THEREFORE, the undersigned, in consideration of the premises and in consideration of the promises of each other, herein set forth, do hereby severally subscribe for the number of shares of the $10 par value common stock of said corporation listed opposite their respective names below at the price indicated below and do hereby severally agree with each other and with said proposed corporation that they will accept and pay the purchase price for such shares in cash, lawful money of the United States, in accordance with this agreement.

It is mutually agreed that John Jones shall be the President of said proposed corporation and that he shall determine all matters in connection with the form and content of the articles of incorporation, bylaws, and application to the Commissioner of Corporations for a permit to issue stock of said proposed corporation, his determination on these matters to be final and binding upon the undersigned.

This agreement is made upon the following conditions:

1. That said proposed corporation shall be incorporated within ninety (90) days from the earliest date on which any one of the undersigned first executed this agreement.

2. That said proposed corporation, when incorporated, shall with reasonable diligence apply for and secure from the Commissioner of Corporations of the State of California a permit authorizing the issuance of the shares subscribed for herein.

This agreement may be executed in any number of counterparts which, taken together, shall constitute the same agreement.

Name and Signature	Date of Signing	Number of Shares Subscribed For	Total Purchase Price

As the majority "revocable offer" view would hold legally insufficient the language: "in consideration of the promises of each other," it is suggested that a third condition be included:

3. That this preincorporation subscription agreement becomes legally binding upon each subscriber hereto upon his signature; and, each subscriber promises to each of the other subscribers, and the other subscribers collectively, that he will not attempt to withdraw or revoke his subscription prior to incorporation of the said proposed corporation or for ninety (90) days, whichever first occurs.

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* Member, Second Year Class; Lt., United States Air Force.